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THE HAYEK MOMENT

Llewellyn H. Rockwell, Jr.

Lecturing at the London School of Economics from 1931 to 1950, F.A. Hayek was nicely positioned to counter the rising influence of J.M. Keynes. Keynes's new vision of macroeconomics was a resurrection of old fallacies but with a modern twist: an open call for a consolidated state to manage investment. More than anyone else, and under the pretense of explaining the economic crisis of the time, Keynes gave intellectual credence to the rise of managerial states in America, the UK, and Europe during the '30s and the war.

Hayek countered with a defense of laissez-faire beefed up by the insights of the Austrian School of economics. He had worked with Ludwig von Mises in Vienna after the period in which Mises first laid out his business cycle theory. The danger of central banks, wrote Mises, is that they exercise power of interest rates, and can thereby distort the production structure of an economy. They can create artificial booms, which either lead to hyperinflation or economic bust.

Hayek advanced this theory as the alternative explanation for the global depression, and worked mightily all those years to show how the stock market crash was not the onset of the crisis but rather the much-needed liquidation of a preceding boom. He further showed how the actions of the British and American governments were prolonging the crisis.

In the great debates of the period, it was said that Hayek had lost to the New Economics of Keynes and his followers. It was more precisely true that the Keynesians had won not by having better argument but force of government policy. The Misesians and Hayekians of the time decided that they would fight the battle of ideas and thus sprang up a host of institutions that would continue the work of liberty, despite all political impediments.

In a series of lectures named in honor of Hayek and supported by Mises Institute members, the spirit of those years at the London School of Economics is back. The Mises-Hayek explanation for economic booms and busts is receiving all new attention during this current period of recession and market meltdown. The usual Keynesian prescriptions for more consumer spending, ever cheaper credit, and government spending have done nothing to solve the problems in the US, Europe, or Japan. The series begins with lectures by Roger W. Garrison, who has provided the most extended and comprehensive elaboration on the Mises-Hayek theory of the business cycle.

The relevance of Hayek in our times extends beyond just business cycle analysis. In later years, Hayek turned his attention to other matters concerning the methods of science (he decried the "pretense of knowledge" affected by social scientists) and the uses of power in society. His *Road to Serfdom* warned that the regimentation of totalitarian societies can only come to Britain and the US through central planning. What is at stake, he wrote, is not just productive economies but freedom itself.

In this Issue:

In our time, that freedom is threatened by intervention in every aspect of economic life but also through the use of military power. Government not only claims it is smart enough to manage the economy, fix up our communities, run our schools, but also to decide which foreign politicians deserve to be protected and which deserve to be destroyed.

The implicit assumption is always that government knows more and better than the rest of us, and that this knowledge is sufficient to give it rights the rest of us do not have. It is often said that knowledge is power. In the case of government, however, its power vastly exceeds its knowledge.

When Alan Greenspan of the Fed (a branch of government in every important respect) testifies before Congress, legislators listen attentively to find out what he knows about the state of the economy, as if he has some privileged access to high-level data not reported elsewhere. It is further assumed that he knows precisely how to act on it. It is this knowledge that allows him to operate the gears and levers of the economy, so it is believed.

The same assumptions are made about many aspects of government. Many people who have backed war with Iraq assume that the government must know something awful about Saddam that it cannot share with the general public. It's true, they admit, that Saddam does not have nuclear weapons and that there is not public information that suggests he is plotting the destruction of America as we know it. But surely the White House must know something we do not, and know what to do about it, else why would the administration be so intent on removing him from power?

The belief that powerful people know more than the rest of us is a main source of their power.

The belief that powerful people know more than the rest of us is a main source of their power. It's true only to this extent: powerful people are likely to know when they are telling the truth and when they are not. The rest of us are put in a position of having to guess or dig to verify their claims point by point. Experience teaches that politicians often lie. But there's an even more important point: because government activity takes place outside the framework of the market economy, government has no idea how to use the information it does have to achieve social good.

Think of all the bits of information the government had been collecting to assess the likelihood of a terrorist incident. A few warnings among tens of thousands of tips did not suffice to prevent this destructive attack. The accumulation of information has grown steadily more voluminous. The government is in no better position to make judgments about it today than it was two years ago.

In contrast, insurance companies are in the business of assessing risk all the time, and they do this by means of a system of profit and loss, which Mises demonstrated is essential to a rationally organized society. Government, on the other hand, just collects piles of data and is completely at a loss on how to assess the relative likelihood of any particular scenario, or what to do about it.

Remember this winter's now-famous announcement that Americans should stock up on duct tape to protect themselves from chemical warfare. People rushed to the stores and cleaned out the shelves. Later it turned out that duct taping windows can be very dangerous and even cause asphyxiation. Not only that: the tip concerning the coming bio-terrorism was a hoax. The "high alert"—as if that means anything to regular people—that government told Americans to be on was not justified.

In contrast, the private sector enhances security through peaceful and normal means. Home insurance companies give premium breaks for people who install alarm systems. Health insurers charge more for people who live dangerously. Premiums

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go up when risk is high and they fall when it is low. Through this mechanism, people are encouraged to adopt safe ways of living or pay the difference if they choose not to. Those who contract to provide security face competition and have the incentive and means to provide what they promise. What a contrast to the chaotic and fumbling ways of government security provision!

But failure does not deter the state. Indeed, we are now asked to believe that the White House is not only omnipotent but omniscient as well. These people in government presume to make definitive judgments about the entire Iraqi ruling class, even going so far as to say that they know the secret hostility of a huge range of people toward Saddam, which thus qualifies them (who just happen to have essential technical knowledge) to help in administering the country. They can't possibly know this. That they believe they can, or they believe we will believe their claims to know, is incredible and frightening.

The alarming reality brings to mind Hayek's Nobel Prize lecture in 1974. With great courage, Hayek spoke of the tendency of economists to presume that they know things about human behavior that they do not and cannot know. They do this because they try to apply the models of the physical sciences to explain human action, always with an aim toward controlling the outcomes of human choice.

In truth, human action is too complex and subjective to be accessed by social scientists, and the attempt will always lead to abysmal failure. Hayek went on to explain how his critique of positivist economic modeling applies more broadly to anyone who would attempt to imitate the form while missing the substance of scientific procedure.

"But it is by no means only in the field of economics that far-reaching claims are made on behalf of a more scientific direction of all human activities and the desirability of replacing spontaneous processes by 'conscious human control'." He mentions that the point applies to sociology, psychiatry, and the philosophy of history.

Hayek was raising an objection not to the idea of omniscience but of the possibility of accessing even mundane knowledge. No small group in government, much less a single person, can accumulate and sort through the kinds of information necessary to administer society, much less destroy and reconstruct one, as the Bush administration proposes to do throughout the Gulf region and the Middle East.

The attempt to assemble such a list is an act of power, not intelligence. We are being asked to make an enormous leap of faith that the Bush administration has somehow solved the great problem that afflicts us all: the limits of human comprehension. Because of those limits, we are right to try to limit the ability of men to exercise power over their fellows, at home or abroad.

Thus does Hayek's point apply to politics, especially to politics, even more especially to the politics of the military machine. The social scientist who believes he has the master plan to run the world is enough of a menace. But the politician who believes this, and is contemplating war, can bring about massive amounts of destruction and death. In these nuclear days—and let us say what we don't like to contemplate but which is nonetheless true—he can bring about the end of the world as we know it. As Hayek notes, a tyrant who carries the pretense of knowledge too far can become "a destroyer of civilization."

"If man is not to do more harm than good in his efforts to improve the social order," said Hayek, "he will have to learn that . . . he cannot acquire the full knowledge which would make mastery of the events possible." To believe otherwise is foolhardy and dangerous. "The recognition of the insuperable limits to his knowledge ought indeed to teach the student of society a lesson of humility which should guard him against becoming an accomplice in men's fatal striving to control society." ● FM

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The Truth About North Korea

Jude Blanchette

After several years of scant media coverage, the Democratic People's Republic of Korea (DPRK) is back in the public spotlight. Its admission late last year that it had revived its nuclear program has caused a flurry of Washington war planning. For the media, North Korea's leader, Kim Jong Il, has proved to be an irresistible caricature of the evil dictator. While much has been made about the political evils of this autocratic, Stalinist leader, little attention has been paid to the real tragedy of the North Korean situation: the economic destruction wrought on North Korea's population by decades of socialism. By turning all property over to the state, the North Korean government precluded the possibility of economic calculation. For over 50 years, the inhabitants have been imprisoned by destitute poverty.

Out of sheer survival instinct there has been a recent effort on the part of the government to reform its economy. The "reforms" are doomed to fail, however, because they attempt to arrive at capitalist outcomes by using socialist means.

Since its inception, the DPRK has been modeled after the collectivized production economy of the Soviet Union, with state-owned enterprises primarily focusing on the development of industrial and agricultural industries. In 1955 North Korea's founder and first leader Kim Il Sung (the father of Kim Jong Il) conceived Juche, the economic system of self-dependence. While this is not a new path for a socialist country to follow, it has taken on a somewhat mystical importance in North Korea. Nonetheless, it was only a matter of decades before the government had eroded the country's capital stock and delivered its people into poverty.

The 1990s proved to be a particularly devastating period for North Korea, with GDP growth declining every year from 1990 to 1998. This rapid decline in economic output, coupled with a three-year famine that claimed the lives of an estimated two million people, provides an important backdrop for the events transpiring on the Korean Peninsula today.

While the North Korean government has traditionally remained skeptical of economic reforms that hint of capitalism, the past year has seen a flurry of news reports describing an atmosphere of change in Pyongyang. As reported in the *Washington Post*, Kim Jong Il circulated a memo early last year in which he called for "real profits" and an end to state subsidies. Then, last summer, the government enacted its reform package in an attempt to boost the failing economy. While the major newspapers ran headlines such as "North Koreans' New Assignment: Fundamentals of Capitalism" and "A Taste of Capitalism in North Korea," the adopted policies contained little that resembled market reforms.

Price increases by government fiat typified the policies. In order to increase the productivity of workers, wages were arbitrarily raised by 900 to 2,000 percent. As National Public Radio reported, "the government printed more money, and on one day this past summer, every North Korean worker received a 2,000 percent raise." That the wealth of a country is independent of the monetary printing press is apparently unknown to the North Korean government.

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Also enacted concurrently with the wage increases was a rise in prices for almost every commodity. The price of rice, the staple of most Asian diets, rocketed by 4,000 percent, while the price of electricity rocketed 5,900 percent.

Because private property remains illegal, these new prices for labor and goods are still government controlled and therefore utterly useless. Severe distortions in the market abound and economic calculation remains impossible. It was this fundamental misunderstanding of the price system that typified the socialist calculation debate in which the socialist economists believed that the rational allocation of goods and services could be created through the emulation of a price system without private property. But as

Mises wrote, "The value of the price paid is called cost. Cost is equal to the value attached to the satisfaction which one must forgo in order to attain the end aimed at." Prices are of little use unless they reflect the outcome of consumers' and producers' subjective valuations, valuations that only arise with private property.

The *Washington Post* reports that in order to learn the workings of a market, "Kim has traveled to more than a dozen cities in China and Russia—lingering in stores, factories and stock exchanges." That one can gain an adequate grasp of the market economy by standing in a store shows the absurd understanding the North Korean economic czars have of a free market.

In another desperate attempt at economic reform, the North Korean town of Sinuiju has been designated a free trade zone. This small enclave on the Chinese border will attempt to entice foreign investment and allow the functioning of a market economy. It began, as all good capitalist economies do, with a legislative mandate.

Second, and also very important for market economies, was the forced removal of the city's 500,000 residents and its repopulation by 200,000 government chosen workers. In a final act of free-market acumen, the government chose to wall in the city and appoint China's second richest man, Yang Bin (who has since been arrested by the Chinese government for tax evasion) to oversee economic planning.

Closer in resemblance to a Russian gulag than anything else, the Sinuiju Special Administrative Region is doomed to failure. Capitalism cannot be decreed, nor can any form of socialist central planning emulate its outcomes. As Rothbard wrote, "you cannot plan markets. By their very nature, you can only set people free so that they can interact, exchange, and thereby develop markets themselves." In addition, adjusting the price level by government decree ignores the foundation of prices and fails to solve the distortions that have destroyed the North Korean economy.

True reform for North Korea would entail the immediate and total removal of the government from the economy. An economy based on private ownership of the means of production will provide the only avenue of escape for a people wrecked by 50 years of socialism and its corollary, central planning.

Some would argue that this "big bang" approach would destabilize the country, bringing about painful structural readjustments that would be too costly in the short run. Gradualism like in the case of China, it is argued, would provide the benefits of liberalization without the costs. Obviously these critics overlook the government-caused famine that murdered two million North Koreans. If this is the cost of stability then the chaos that follows rapid desocialization must certainly be preferable.

In truth, North Korea is on the verge of collapse and stability of the region can only come about with swift desocialization. The adoption of capitalism is now the only policy that can stop the instability that would follow the sudden and total crash in the economy.

As our government and media ponder the predicament of this isolated nation in the Korean peninsula, we would do well to remember the pivotal role socialism played in its creation. One can only hope that the news headlines breathlessly proclaiming North Korea's adoption of capitalism will one day prove true. ● FM

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Myths of the Crash

Sean Corrigan

Three years into one of the most severe bear markets in history, the most striking feature of the typical economic discussion is the persistent state of denial about how perilous our situation truly is. Also notable is the unthinking promulgation of a species of economic fallacies which, though long since discredited, keep springing up like weeds to choke our reasoning about where we might go from here and, therefore, of how we should be preparing to act. Let us take a look at a few of the more important reasons.

• Myth #1: The consumer is two-thirds of the economy: so long as he is spending, we can avoid recession.

Yes, the private consumer makes up 70 percent or so of GDP, but GDP is not the economy in the sense that the map is not the territory. The concept of GDP was cooked up in the 1930s by Simon Kuznets to help Roosevelt's Mussolini-inspired New Dealers apply Keynes's flawed General Theory to the command economy they wished to create. The National Bureau of Economic Research which was set up to do this received a tremendous boost to its influence and funding in World War II.

When you look to GDP for a guide, you are relying upon a methodology responsible in great part for protracting the business collapse of 1929–30 into that decade of woe, the Great Depression, and then of assisting the assumption of a totalitarian control of resources in wartime.

If we are going to intone a truism, a better one would be "the producer is 100 percent of the economy." Without production, not only are there no goods and services to buy, but no means with which to buy them. As for paper money and electronic credit, they are convenient but dangerous fictions that mask this essential truth. The sooner we start to focus on this, the better our decisions—whether as policymakers or investors—will become.

• Myth #2: Lower interest rates and easy credit will promote recovery.

Just as policy in the second half of the '90s led a whole host of entrepreneurs—many of the honest and gifted ones, as well as the crooks and the charlatans—into the blind alley of the boom, the current focus on consumption and easy money is not helping the survivors, but is actively hindering them.

Easy money is preventing the rapid liquidation of bad businesses which thus remain to cling on to scarce resources—whether human, physical, or monetary—rather than scrapping them or selling them to others who are able to make better use of them.

From the perspective of business—particularly up at the specialized, higher-order, capital goods end on which our future prosperity rests—easy money is doing little more than to prevent resource costs from falling sufficiently into line with output prices so that they can, once more, hope to make a profit.

If we have a problem today, it is not the phantom of overproduction, but the very real bane of overconsumption. Promoting consumption in order to provide an artificial support to expenditures—without caring what form it takes—may provide a temporary stay of execution for some over-extended companies (and a source of revenue on which to rebuild banking finances). But it nonetheless consumes capital; that is, it takes resources out of reproductive use and puts them into exhaustive use instead.

To take just the worst two cases, in the UK personal indebtedness is rising at the rate of nearly 1 percent of disposable income a month—meaning households are borrowing £3.70 for every extra £1 of income. In the US, personal debt, measured as a fraction of the sum of wages and proprietors' income, having been relatively stable at 140 percent for nearly a decade prior, has soared to 166 percent in just the past two years—implying that every extra $1 earned has been accompanied by a mind-boggling $10.50 borrowed!

And to what purpose is this perilous gearing, this destruction of middle and working class financial security, being promoted by central banks and finance ministers? So people can consume more than they

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can produce and "heal" the economy, by somehow helping absorb the supposed "oversupply" of goods and equipment which was the boom's legacy.

It would take too long to explain here why there can never be a generalized oversupply on the free market—merely a specific, or a mispriced, one—or why what we suffer from is not a surplus of capital goods in general. We are in fact faced with an imbalance in their composition of supply, compounded by what is actually a shortage of sufficient genuine capital resources with which to complement and so profitably to employ the capital we do have.

But, consider two sets of questions to provoke some thought about this:

Will easy money help Lucent sell enough network gear to survive? Has it helped find a market for the 500 million miles of mostly unlit fiber optic cable laid around the world? Would it have made WorldCom solvent? Has it helped Fiat, or Ericsson, or Sabena, or British Energy—any more than it has helped Daiei, or Sogo, or Nitto Kogyo in Japan?

Are we really faced with oversupply? Do you have the exact model of car you want? Is your house fitted out as luxuriously as you would wish? Do you get enough beer to drink? Do your kids tire of sweets, or your wife of new shoes? Do you have access to all the medical care you want, when you want it? If you can answer "Yes" to any of those you are a hermit, a liar, or Larry Ellison.

Otherwise there can never be a case of "oversupply," whatever the collectivists tell you.

• Myth #3: Government spending can promote growth.

This idea of the State as our savior is one of the oldest fallacies of all—the broken window fallacy which Frédéric Bastiat dealt with so firmly nearly 200 years ago. To see this, ask yourself where the government gets the bulk of the resources it wishes to spend in the first place? From you, of course.

(Even if it employs you, by its very nature it is likely to use your labor to do things that are either extra-economic or sub-economic, so still occasioning a partial or complete loss of your effort.)

It borrows from you, it taxes you, it requires licenses and user fees. It fines you if you break its petty rules. It steals from you through the inflation its chartered central bank helps create.

And then what? It decides where the money goes. It decides which corporate cronies will get your cash. It decides whether you must put aside thoughts of a new suit, so it can buy one for its newly hired traffic warden instead. And all the while it pays one army of bureaucrats to lift the money out of your left pocket, another army to spend it where it buys the most votes, and finally a third—much smaller—army to put some of it back in your right pocket, so you don't realize the full extent to which you've been exploited.

None of this creates one single dollar of new wealth: it merely redistributes it. It shrinks the space in which the market can allocate scarce means to their most urgent ends, it corrodes the stock of capital, and it removes incentives to self-improvement along with property rights.

If running big deficits were an answer to our problems, why did Argentina go bust? Why has Japan been stuck in a hole for 14 long years?

If government spending were the answer, why didn't the Berlin Wall get knocked down by anxious Frankfurters fleeing east?

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• Myth #4: All tax cuts are good.

Well, who knows what the short-run response of the market will be, but economically, unless any tax cuts are financed by offsetting reductions in government outlays, we are just back to the transfer problem outlined above.

As for the much-feted dividend cut, why stop at the abolition of double taxation, why not abolish single taxation, too? Why not make dividends tax deductible like interest payments are (or even remove interest deductibility entirely to stop subsidizing corporate and real-estate indebtedness at the expense of equity issuance)? If you add dividends paid in the US to the net of stock buybacks and issuance, you find the cumulative total payout for the past 50 years is a cool 95 percent of all the after-tax profits earned this past half century. There's not a lot US business can do to increase that sort of ratio!

• Myth #5: We are staring deflation in the face.

Let me offer a strict definition of deflation—useful not just for terminological exactitude, but to avoid an impediment to clear reasoning. Deflation is a fall in the amount of money beneath the freely expressed demand for it—it is not an observed fall in prices, even when that is generalized, though such an event may be the result of a deflation.

So, if we said that the Fed has presided over an M3 increase of over $1.5 trillion dollars since the Great Bear Market started on Labor Day 2000—more money than even existed as recently as 1980!—or that G7 broad money went up by a seventh, or by $3.4 trillion dollars, in the past 12 months, we cannot say that we have had deflation.

Moreover, what it has also ignited is a housing bubble. US prices increased 15–20 percent nationwide in 2002—a gain which jumps to 30 percent on slightly higher recorded sales in California, and national dollar turnover volumes soared 25 percent. It may have taken a while, but commodity prices, too, have responded vigorously.

We should never say never, for we in the West carry unprecedented amounts of debt on the shallow foundation of our failing global productive competitiveness. But we certainly haven't seen any evidence of deflation yet—only just enough mindless chatter about it to deter those entrepreneurs not already hindered by the combined shackles of the bubble overhang, bad monetary and fiscal policy, over-regulation, the imposition of tariffs, high energy prices and the threat of who-knows-what unintended consequences arising out of the war on terror.

Inflation, as ever, is the sleeping dragon the authorities are desperately trying to rouse, as Governor Bernanke of the Fed so infamously pointed out for us recently. Deflation is still a fairy tale bogeyman at this stage—a Troll with which to frighten the children into silence and compliance.

• **Myth #6: Stocks always go up in the long run. The rally will start next quarter, or the quarter after that, or the quarter after that.**

Well, they have done that in the last six decades, in nominal terms, at least—except, that is, when they haven't, like, for instance, the whole stretch from 1966–1982! In real terms it's even more chastening to realize that from the Fed's inception in 1913, it was one big, go-nowhere roller-coaster ride to 1949 and that we were back pretty much at these levels over three decades later, in 1982. 1929's peak was not exceeded until the '50s, and it was revisited as recently as 1991. It took until the start of this bubble, in 1995, to recoup the 1966 high.

Moreover, the 1920s Bull market saw a 340 percent real term gain—all of which was then surrendered. The more sedate post-WWII run to the '66 top was again around 340 percent: all was given back. The run this time, taken from the 1987 Crash lows was, once again, a very similar 330 percent—which could be a very bad omen, indeed.

Stocks go up in the long run, alright, but they also go down. Especially when we adjust for inflation, when they are not cheap to start with, and when business everywhere has to cope with the legacy of two generations of debt-fueled capital consumption, the return of big government from its brief hibernation and the shattering of the international consensus and the superficial neoliberal harmonies it imposed.

Recessions are a time for the careful and conservative stewardship of resources monies and for those charged with this to display a willingness to challenge prevailing myths, whether these arise from economic sophistry, or from institutional prejudice and intellectual inertia. If we can all become convinced that these are aims well worth achieving—and we are not precluded from such a goal by the backhanded intrusions of bad ideas working in league with the State—this recession might actually turn out to have been fully worth the cost. ● FM

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